

DEPARTMENT OF STATE REVENUE

04-20130604.LOF

Letter of Findings Number: 04-20130604
Use Tax
For Tax Years 2010, 2011, and 2012

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective as of its date of publication and remains in effect until the date it is superseded by the publication of another document in the Indiana Register.

ISSUES**I. Use Tax – Liability.**

Authority: IC § 6-2.5-1-2; IC § 6-2.5-1-27; IC § 6-2.5-2-1(a); IC § 6-2.5-3-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-3-6; IC § 6-2.5-4-1; IC § 6-2.5-5-1 et seq.; IC § 6-2.5-5-3; IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Rhoades v. Indiana Dept. of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); Ind. Dept. of State Revenue v. AOL, 963 N.E.2d 498 (Ind. 2012); USAir, Inc. v. Indiana Dept. of State Revenue, 623 N.E.2d 466 (Ind. Tax Ct. 1993); Indiana Dept. of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983); Department of Revenue v. Kimball International, Inc., 520 N.E.2d 454 (Ind. Ct. App. 1988); Indianapolis Fruit Co. v. Dept. of State Revenue, 691 N.E.2d 1379 (Ind. Tax Ct. 1998); Indiana Dept. of State Revenue v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); [45 IAC 2.2-2-1](#); [45 IAC 2.2-3-4](#); [45 IAC 2.2-5-8](#); [45 IAC 2.2-5-11](#).

Taxpayer protests the imposition of use tax on the purchase of sodium chloride and parts for its wells.

II. Tax Administration – Negligence Penalty.

Authority: IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1; Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); [45 IAC 15-11-2](#).

Taxpayer protests the imposition of ten percent negligence penalties.

STATEMENT OF FACTS

Taxpayer is an Indiana corporation which manufactures sanitation chemicals and equipment used by food processors and the meat industry. The Indiana Department of Revenue ("Department") conducted an audit for the tax years 2010, 2011, and 2012 and proposed assessments of base tax, penalties, and interest. Taxpayer protests the imposition of use tax on the purchase of sodium chloride and parts for its wells arguing that they are exempt. Additionally, Taxpayer protests the imposition of penalties. An administrative hearing was held, and this Letter of Findings results. Additional facts will be supplied.

I. Use Tax – Liability.**DISCUSSION**

Taxpayer protests the use tax imposed on the purchase of sodium chloride and parts for its wells. All tax assessments are prima facie evidence that the Department's claim for the tax is valid, and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012). The issue before the Department is whether Taxpayer met its burden to prove the Department's assessment is incorrect.

Indiana imposes a sales tax on retail transactions made in Indiana. IC § 6-2.5-2-1(a); [45 IAC 2.2-2-1](#). Indiana imposes a complementary use tax on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction" regardless of the merchant's or transaction's location. IC § 6-2.5-3-2(a); [45 IAC 2.2-3-4](#). The use tax is "functionally equivalent to [the] sales tax." Rhoades v. Indiana Dept. of State Revenue, 774 N.E.2d 1044, 1047-48 (Ind. Tax Ct. 2002). "Indeed, the purpose of the use tax is merely to prevent evasion of the sales tax." Ind. Dept. of State Revenue v. AOL, 963 N.E.2d 498, 501 (Ind. 2012). The person who acquires property in a retail transaction or who uses, stores, or consumes property acquired in a retail transaction in Indiana is responsible for payment of use tax on the transaction. IC § 6-2.5-3-6(b).

The sales and use taxes apply to retail transactions. A retail transaction is a transaction made by a retail merchant that constitutes "selling at retail." IC § 6-2.5-1-2. Selling at retail means a retail merchant "(1) acquires tangible personal property for the purpose of resale; and (2) transfers that property to another person for consideration" in the ordinary course of the merchant's business. IC § 6-2.5-4-1. Tangible personal property is personal property that "can be seen, weighed, measured, felt, or touched" IC § 6-2.5-1-27.

Additionally, for a retail transaction to be subject to use tax, the tangible personal property must be "used, stored, or otherwise consumed" in Indiana. [45 IAC 2.2-3-4](#). For the purposes of Indiana use tax, "[u]se" means the exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). The Indiana Tax Court has recognized that "[t]his is a broad definition" and that "[a]lmost any act not otherwise exempt will constitute a taxable use." *USAir, Inc. v. Indiana Dept. of State Revenue*, 623 N.E.2d 466, 469 (Ind. Tax Ct. 1993).

Taxpayer concedes that the sodium chloride and materials used in "the development of a second well, and the water and pipe system connecting the wells" were acquired in retail transactions, but argues that such transactions are exempt from tax. Retail transactions ordinarily subject to use tax will be exempt if sales tax was paid at the point of purchase. IC § 6-2.5-3-4; [45 IAC 2.2-3-4](#). The legislature also provided specific exemptions from sales or use tax. IC § 6-2.5-5-1 et seq. Exemption statutes are strictly construed in favor of taxation. *Indiana Dept. of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520, 524 (Ind. 1983). Whether a taxpayer qualifies for an exemption from tax is "highly fact sensitive," and it is the taxpayer's burden to prove the exemption criteria has been met. *Department of Revenue v. Kimball International, Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

Taxpayer argues that the sodium chloride and well are part of the Taxpayer's production process and therefore exempt from sales or use tax. Generally, "all purchases of tangible personal property by persons engaged in the direct production [or] manufacture . . . of tangible personal property are taxable." [45 IAC 2.2-5-8\(a\)](#). However, "transactions involving manufacturing machinery, tools, and equipment are exempt" if they are purchased for "direct use in the direct production [or] manufacture . . . of other tangible personal property." IC § 6-2.5-5-3(b); [45 IAC 2.2-5-8\(a\)](#).

To claim this exemption, a taxpayer must first demonstrate that it produces tangible personal property, because "without production there can be no exemption." *Indianapolis Fruit Co. v. Dept. of State Revenue*, 691 N.E.2d 1379, 1384 (Ind. Tax Ct. 1998).

Second, a taxpayer must show that the property was acquired for the "direct use in the direct production [or] manufacture . . . of other tangible personal property." IC § 6-2.5-5-3(b). Courts have recognized that the legislature's "repetition of the requirement that the use be direct" was intended to provide for a narrow construction of the exemption. *Indiana Dept. of State Revenue v. RCA Corp.*, 310 N.E.2d 96, 100 (Ind. Ct. App. 1974). Therefore, to be considered directly used in direct production or manufacture, the property must be "an essential and integral part of an integrated process that produces tangible personal property." *Kimball*, 520 N.E.2d at 457; [45 IAC 2.2-5-8\(c\)](#). Whether property is essential and integral to an integrated process is determined "by identifying the points where production begins and where it ends." *Indianapolis Fruit*, 691 N.E.2d at 1384. The production process "begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required." [45 IAC 2.2-5-8\(d\)](#).

Replacement parts and property used in the normal maintenance or repair of exempt property is also exempt from tax. [45 IAC 2.2-5-8\(h\)](#). Property that is "consumed in direct production by the purchaser in the business of producing tangible personal property by manufacturing. . ." is also exempt. [45 IAC 2.2-5-11\(a\)](#). However, property may not be essential and integral to an integrated production process even though it is "considered essential to the conduct of the business of manufacturing." [45 IAC 2.2-5-8\(g\)](#).

The Department's audit report recognized that Taxpayer produces tangible personal property, i.e. "sanitation chemicals and equipment." Therefore, the issues in this case are whether the sodium chloride and the well are essential and integral to an integrated production process.

1. Sodium Chloride

The audit report states that the sodium chloride "is taxable because it is used to clean the softener (filter) while the softener is out of production." The report recognized that "[w]hen the taxpayer softens the water . . . the softener is like a production machine acting on and changing the water," but found that "when a production machine is shut down for cleaning, anything used to clean the machine is taxable." The audit report found that the

sodium chloride "is used to clean the filter in the softener" and taxable.

Taxpayer asserts that "[t]he sodium chloride is . . . used to 'regenerate' the softener process which is a part of the production process." Taxpayer states that the "water softener is not shut down for cleaning." Taxpayer explains that "[i]n order for the other raw ingredients to be solubilized properly, the water must be treated to remove calcium and magnesium ions and replace them with sodium ions from salt (sodium chloride or potassium chloride). This is accomplished by using a sodium zeolite water softener." The "softener is regenerated with sodium or potassium chloride three times per week to keep [Taxpayer's] production water down to 0-5 parts per million hardness." The "[t]reated water is [Taxpayer's] primary utilized raw material for all of [its] manufacturing." Taxpayer states it uses a different product to clean the softener.

Taxpayer's explanation did not satisfactorily explain the difference between "regeneration" and "cleaning." The process of regeneration is not continuous throughout the production process. Although Taxpayer indicated that the water softener is not shut down for cleaning, its explanation indicates that the process of regeneration occurs only three times per week. This appears to confirm the audit report's finding that the softener is out of production when the "regeneration" or "cleaning" takes place. Taxpayer's explanation, while detailed, does not address the Department's conclusions outlined in the audit report. Therefore, Taxpayer has not met its burden to show that the Department's proposed assessment is incorrect. The sodium chloride has not been shown to be directly used in direct production or manufacture of other tangible personal property; therefore Taxpayer's purchase of the sodium chloride is not exempt. Taxpayer's protest is respectfully denied.

2. Well

The audit report indicates that the wells are not a part of the production process, finding that "parts for wells" were acquired for preproduction activity pursuant to [45 IAC 2.2-5-8\(d\)](#). Taxpayer disagrees indicating that its "production process begins with the well since the well pumps filter impediments and foreign objects found in the extracted water."

For the purposes of this exemption, the production process "begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required." [45 IAC 2.2-5-8\(d\)](#). The Department has consistently held that water wells are not part of the production process. The drawing up and filtering of water is a preproduction activity since it does not directly affect the manufacturing process. The water is transported, not transformed, even though the well pumps filter out "impediments and foreign objects found in the extracted water." Taxpayer's protest is respectfully denied.

FINDING

Taxpayer's protest is respectfully denied regarding the purchase of sodium chloride and the parts for its water wells.

II. Tax Administration – Negligence Penalty.

DISCUSSION

The Department issued proposed assessments for base sales and use taxes, penalties, and interest for the tax years 2010, 2011, and 2012. Taxpayer protested the imposition of the penalties. All tax assessments are prima facie evidence that the Department's claim for the tax is valid, and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012).

A taxpayer who receives a proposed assessment after an audit "is subject to a penalty." IC § 6-8.1-10-2.1(a). The Department shall waive the penalty if the taxpayer demonstrates that the failure to pay the outstanding taxes "was due to reasonable cause and not due to willful neglect." IC § 6-8.1-10-2.1(d); see also [45 IAC 15-11-2](#). The taxpayer may demonstrate reasonable cause by showing affirmatively that it used "ordinary business care and prudence" in not paying the outstanding taxes. Whether a taxpayer demonstrates reasonable cause for penalty purposes is a fact-sensitive question and determined on a case-by-case basis. [45 IAC 15-11-2\(b\)](#), (c).

In this case, Taxpayer has not demonstrated that it used ordinary business care and prudence in not reporting and paying the assessed use tax in this case. Taxpayer's protest is respectfully denied.

FINDING

Taxpayer's protest is respectfully denied.

SUMMARY

Taxpayer's protest is respectfully denied on Issue I regarding imposition of use tax. Taxpayer's protest is respectfully denied on Issue II regarding imposition of negligence penalties.

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